

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Klehs Analyst: Jeff Garnier Bill Number: AB 1628
Related Bills: None Telephone: 845-5322 Introduced Date: Feb. 22, 2005
Attorney: Patrick Kusiak Sponsor: Franchise Tax Board

SUBJECT: Modify The Penalty For Failing To Withhold At Source

SUMMARY

This bill would change the application of the failure to withhold penalty.

PURPOSE OF THE BILL

The purpose of this Franchise Tax Board sponsored bill is to provide an effective tool to increase compliance with existing tax law.

EFFECTIVE/OPERATIVE DATE

The provision would be effective and operative beginning January 1, 2006.

POSITION

Support.

On December 2, 2004, the Franchise Tax Board voted 2-0, with the representative from Department of Finance, abstaining to sponsor the provisions of this bill.

ANALYSIS

Background

The department's withhold at source program requires withholding of tax from payments of income derived from California sources received by nonresident contractors, beneficiaries of estates and trusts, partners, and individual resident and nonresident sellers of California real property. The obligation to withhold is generally borne by the party paying the item of income to the taxpayer-recipient. This program is distinct from withholding on regular wages, which is administered by the Employment Development Department.

Current Federal Law

Generally, a percentage of income paid to a nonresident alien or a foreign corporation for services or for gain on the sale of real property must be withheld. The withholding obligation is imposed on the "withholding agent." A "withholding agent" means the person that is normally responsible for the disbursement of the funds. The withholding agent is frequently the person paying for the services or purchasing the property, but can also be an attorney, escrow person, broker, or other intermediary.

Board Position:

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Department Director

Date

Gerald H. Goldberg

4/4/05

A penalty is imposed on withholding agents if they fail to withhold on payments to a nonresident alien or foreign corporation. The amount of the federal penalty is equal to the amount of tax the taxpayer ultimately fails to pay, but cannot exceed the amount that should have been withheld. Therefore, the penalty can be assessed only once the IRS determines the amount of tax the taxpayer failed to pay. The penalty is excused if the failure to withhold is due to reasonable cause.

Current State Law

California law is similar to federal law except California law expands withholding requirements to include the sale of California real property by any individual. The withholding rate for California source income paid to a nonresident or corporation with no presence in California is 7%. The withholding rate for the sale of real property is $3\frac{1}{3}\%$ of the sales price. The buyer of the real property is generally the withholding agent. Like federal law, the withholding agent is normally the person paying for the services or distributing the money.

Except for buyers of real property, the amount of the penalty imposed on the withholding agent is calculated in a method similar to federal law, namely the amount of tax the taxpayer failed to pay, but not greater than the amount that should have been withheld. The penalty can be assessed only after the department determines the amount of tax the taxpayer failed to pay.

The penalty amount for buyers of real property located in California is calculated in a different manner. The penalty is the greater of \$500 or 10% of the amount required to be withheld. The penalty may be assessed immediately after the failure to withhold.

Administration of the Penalty

The primary purpose of the penalty is to ensure compliance with the withholding requirement. There are three weaknesses in the effectiveness of this current penalty regime:

- Whether the penalty is imposed is dependent on both the withholding agent's failure to withhold and the taxpayer's failure to ultimately pay the tax. The penalty amount is based solely on the amount of tax owed by the taxpayer, rather than the withholding agent's failure to withhold. This weakens the effectiveness of the penalty because the penalty is for failure to withhold, not for the failure of the taxpayer to pay the taxes.
- The department must have the taxpayer's return to determine the amount of the penalty. If the taxpayer's return combines the payment of income in question with other income, the department has to contact the taxpayer to determine if both the payment was reported as income and the corresponding tax was paid. This is ineffective because it essentially means every taxpayer that should have been withheld at source must be audited.
- The time between the failure to withhold and the assessment of the penalty can be 22 months. This time lag discourages timely compliance.

Some withholding agents (e.g., promoters of entertainment events and escrow persons) are aware of the weaknesses in the current failure to withhold penalty, resulting in withholding agents that fail to withhold diligently or refuse to withhold altogether.

Under present law, withholding agents have little incentive to comply with the withhold at source law because the penalty for failure to withhold is ineffective for three reasons:

- Assessing the penalty is dependent on the actions of persons other than the withholding agent.
- Determining the penalty amount requires substantial FTB resources.
- Assessing the penalty occurs only once a substantial amount of time passes after the failure to withhold.

THIS BILL

This bill would permit the failure to withhold penalty to be assessed immediately after a failure to withhold occurs and to base the imposition of the penalty solely on the agent's failure to withhold. The penalty amount would be equal to the greater of \$500 or 10% of the difference between the amount withheld and the amount required to be withheld. This rule is similar to the rule for buyers of real property under present law.

This bill would not remove an exception to the penalty for real estate escrow persons. Under present law, if the real estate escrow person fails to inform the buyer of the real property of the withholding requirements the real estate escrow person becomes responsible for the withholding, and thus, subject to the penalty. The real estate escrow person would not be liable for the penalty if the taxpayer, the withholders, files a timely return and pays the proper amount of tax on the property transfer.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

OTHER STATES' INFORMATION

The laws of *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York* were surveyed because their tax laws are similar to California's income tax laws. *Illinois*, *Massachusetts*, *Michigan*, and *Minnesota* require withholding at source on various entities. While it is clear that penalties exist for failure to file withholding taxes, it is unclear if a specific withholding at source penalty is collected in these states. Information regarding withholding at source was not readily located for *New York*.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue gains:

Modify The Penalty For Failing to Withhold At Source		
Fiscal Years		
\$ in millions		
2005-06	2006-07	2007-08
\$.5	\$1	\$1

Based on limited information and the discussion below, the potential revenue enhancement of this bill is estimated to be on the order of \$1 million annually, and is due primarily to a projected increase in compliance as a result of this proposal.

Revenue Discussion:

Based on departmental data, approximately \$23 million in personal income tax (PIT) withholding for the tax year 2001 remains unclaimed. These unclaimed tax payments represent amounts withheld by withholding agents and remitted to the department but were unclaimed as a tax payment on any tax return. Significantly, all of the taxpayers representing this \$23 million in withholding failed to file a return. It is estimated that the \$23 million represents 75% of the tax that would have been due if the taxpayers properly reported the income received. Thus, the total tax due on the income received is estimated to be \$31 million (\$23 million / 75%). The difference between the amounts withheld and tax due on the income is attributable to the withholding rates of 7% and the highest marginal tax rate of 9.3%.

Unclaimed corporate withholding is estimated to represent 30% of the PIT unclaimed amount of \$7 million. Assuming corporate withholding behavior is similar to that of PIT, it is estimated that total tax due on the income is \$9 million.

The above yields approximately \$40 million (\$31 million + \$9 million) in total taxes due from the income for a difference of \$10 million (\$40 million – (\$23 million + \$7 million) attributable to non-compliance. This number was then grown to approximate 2004 levels (\$12 million). Assuming an improved compliance rate of 10%, estimated revenue would be on the order of \$1 million annually.

POLICY CONCERNS

For the 2004 calendar year, the department collected approximately \$1.2 million through its withholding at source program. This proposal would ensure continuing compliance with the withholding requirements and would increase compliance above existing levels, thus making the failure to withhold penalty more effective.

LEGISLATIVE STAFF CONTACT

Jeff Garnier
Franchise Tax Board
845-5322
jeff.garnier@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
brian.putler@ftb.ca.gov